STATE OF CALIFORNIA

# DEPARTMENT OF INSURANCE

300 Capitol Mall, 17th Floor
Sacramento, CA 95814

## PROPOSED DECISION

## FILE NUMBER REG-2007-00053

**In the Matter of:** Proposed adoption or amendment of the Insurance Commissioner's regulations pertaining to pure premium rates for workers' compensation insurance, California Workers' Compensation Uniform Statistical Reporting Plan—1995, Miscellaneous Regulations for the Recording and Reporting of Data, and the California Workers' Compensation Experience Rating Plan—1995. These regulations will be effective on **January 1, 2008**.

### EXPLANATION AND HISTORY

A public hearing in the above captioned matter was held on October 23, 2007 at the time and place set forth in the Notice of Proposed Action and Notice of Public Hearing, File Number REG 2007-00053 dated September 21, 2007, which is included in the record. At the conclusion of that hearing, and as noticed in the Notice of Proposed Action and Notice of Public Hearing, the hearing officer announced that the record would be kept open for additional written comment until 5:00 p.m. on Tuesday, October 30, 2007. The record was closed at 5:00 p.m. on October 30, 2007.

The record discloses the persons and entities to whom or which the Notices were disseminated. The Notice summarized the proposed changes and recited that a summary of the information submitted by the Insurance Commissioner in connection with the proposed changes was available to the public. In addition, the "Filing Letter" dated September 20, 2007 submitted by the Workers' Compensation Insurance Rating Bureau of California (WCIRB) and related documents were available for inspection by the public at the Sacramento office of the Department of Insurance and were available online at the WCIRB website, www.wcirbonline.org.

The WCIRB's filings proposed Pure Premium Rates that reflect insurer loss costs and loss adjustment expenses and adjustments to the California Workers' Compensation Experience Rating Plan—1995 to conform to the proposed Pure Premium Rates. In addition, the WCIRB has proposed amendments to the California Workers' Compensation Uniform Statistical Reporting Plan—1995, Miscellaneous Regulations for the Recording and Reporting of Data, and California Workers' Compensation Experience Rating Plan—1995.

Testimony, written and oral, was taken at a hearing in San Francisco on October 23, 2007 and exhibits were received into the record. Additional documentation requested by the hearing panel was submitted subsequent to the hearing but prior to the close of the time period to receive written comment along with correspondence and documents submitted by the public. The matter was submitted for decision at the conclusion of the period to receive written comment on October 30, 2007. The matter having been duly heard and considered, the following Proposed Decision and Proposed Order are hereby made.

## THE PURE PREMIUM RATES

Pure Premium Rates approved by the Insurance Commissioner reflect only loss costs, including loss adjustment expenses; they do not include any provision for general expenses, commissions, other acquisition expenses, premium taxes, or profits.

The Insurance Commissioner's adopted Pure Premium Rates are advisory only. The law does not require insurers to adopt these rates, and insurers may file rates as they deem appropriate so long as they are in compliance with the California Insurance Code and associated regulations and are neither discriminatory nor affect an insurer's financial solvency. These Pure Premium Rates are only an actuarial measure of the minimum required to cover those loss costs and do not reflect the actual premiums that insurers may charge employers.

The Pure Premium Rates proposed by the WCIRB in its September 20, 2007 filing are 4.2% higher (+4.2%) than the Pure Premium Rates that were approved effective July 1, 2007. In a supplemental filing, the WCIRB amended its proposal to 5.2% higher (+5.2) than the Pure Premium Rates that were approved effective July 1, 2007 based upon the changes to temporary disability benefits enacted in AB 338. These proposed rates were based on the WCIRB's analysis of aggregate loss and premium experience valued by the WCIRB as of June 30, 2007.

For the reasons detailed below, the Department of Insurance proposes to adopt Pure Premium Rates that are 3.5% higher (+3.5%) than the current rates—those that have been in effect since July 1, 2007. The pure premium rates adopted herein are based on the hearing testimony and an examination of all materials in the record by the hearing panel, which included two of the Department's senior actuaries, Ronald Dahlquist and Eric Johnson, who both did the primary analysis and determination of the adjustment of the Pure Premium Rates contained in this Proposed Decision.

## ACTURIAL DISCUSSION/DETERMINATION

### Effects of Legislative Changes

January 1, 2005 Permanent Disability Rating Schedule

In this filing, the WCIRB assumes that the 2005 PDRS has lowered permanent disability costs by 60%. In the July 1, 2007 filing, the WCIRB assumption was a 50% decrease. In the Proposed Decision on that filing, we estimated the PDRS impact at -61.25%. As the WCIRB assumption is finally in line with our own, we accept it.

Assembly Bill 338

The governor signed Assembly Bill 338 into law on October 13, 2007. The new law maintains the maximum compensation for temporary disability at 104 weeks, but extends the time limit during which these benefits can be paid from two years past the date of first payment to five years from the date of injury.

The WCIRB made a supplemental filing on October 19 amending its original filing to include its estimate of the effect of this law change on benefits. The Bureau's estimated effect was an increase in indemnity benefits of 2.3%, and an increase in total benefits of 1.0%.

The WCIRB's estimated effect breaks down as follows. The WCIRB's estimate of the direct effect of AB 338 is an increase of 0.8% of total benefit costs. When an assumed increased utilization impact is included, the effect increases to 1.2% of total benefit costs. Finally, the application of the 20% reduction for shortened TD duration results in the Bureau's final estimate of 1.0% of total benefit costs.

Mr. Frank Neuhauser of the University of California Data/Survey Research Center provided written comments on behalf of the Commission on Health, Safety, and Workers' Compensation. In his comments, he agreed with the WCIRB's method for estimating the direct impact of AB 338 on temporary disability costs, but disagreed with the Bureau's estimation of the utilization effect associated with the direct impact. He stated that he believed that there would be no increase to claim frequency due to AB 338, because the benefit change only allows additional payments beyond two years after the date of first payment. Mr. Neuhauser also disagreed with the WCIRB's automatic assumption that LAE would increase proportionately with the increase in benefits caused by AB 338, citing historical experience that shows LAE ratios to loss increasing when losses decline and decreasing when losses increase.

Mr. Kilbourne, Actuary for the Public Members, did not comment directly on the WCIRB estimate of the impact of AB 338. However, he implied that he accepted the WCIRB estimate when he stated that he thought the filing as a whole was acceptable except for the loss adjustment expense provision.

The WCIRB estimate is necessarily based on analysis of pre-reform data; in order to evaluate the impact of the five-year time limit on payments, it is necessary to have data that is more than five years old. We agree the WCIRB estimate of the direct effect of AB 338, prior to the judgmental 20% reduction, is a reasonable estimate of the effect of the bill, if pre-reform temporary disability payment patterns still hold in the post-reform environment. The Bureau presents no data that would shed light on this issue, but applies a judgmental 20% reduction to the calculated pre-reform effect based on the presumption that temporary disability payment duration has shortened, on average, in the post-reform period.

The Bureau's 2007 Legislative Cost Monitoring Report is the latest in an ongoing series of reports prepared by the WCIRB for the purpose of retrospectively evaluating the effect of each of the various reform provisions enacted into law since 2002, based on the actual post-reform experience that has emerged to date. In its section on temporary disability reforms, the report states that it is premature to retrospectively assess the cost impact of the SB 899 temporary disability reforms at this time. We agree with this assessment.

The report goes on to state, however, that there is a post-SB 899 decline in temporary disability duration of approximately 15%. The CWCI study of temporary disability, which is included as Attachment G of the report, shows that the average number of days of temporary disability benefits paid within the first 12 months of the life of each claim has declined by 13.3% after the SB 899 limit became effective, and the average number of days of temporary disability benefits paid within the first 24 months has declined by 17.4%. It is significant that these impacts have nothing to do with the limitation imposed by SB 899, which only limits payments made more than 24 months after the first benefit payment. It also appears that the Bureau's judgemental reduction of 20% for the presumed reduction in temporary disability duration has a reasonable basis in fact.

While we are sympathetic to the argument that the utilization effect may be less than 26% for such a small change as this one, we do not believe there is sufficient evidence to justify departing from our practice of accepting the 26% utilization effect for all benefit changes. Therefore, we accept the WCIRB's estimate of the effect of AB 338 on losses.

We agree that the LAE percentage provision should not be held constant as a result of the AB 338 effect, since we accept the argument that historical experience demonstrates that LAE will not increase or decrease to the same extent as losses increase or decrease. We assume that the percentage increase in LAE will be half of the percentage increase in losses due to AB 338. Since our estimate of the effect of AB 338 on losses is an increase of 1.0%, we estimate that LAE dollars will increase by 0.5%, and the ratio of LAE to loss will decrease by approximately 0.5%. This has a very modest effect, lowering our selected LAE provision from 25.0% of loss to 24.9% of loss.

**Loss Adjustment Expense**

The WCIRB filing discussion of loss adjustment expense (LAE) begins by providing a 21-year history of industry calendar year paid allocated loss adjustment expense (ALAE) and unallocated loss adjustment expense (ULAE) as percentages of paid loss. The Bureau asserts that in recent years, calendar year paid LAE has been relatively stable, while losses have declined due to legislative reforms, resulting in increasing ratios of paid LAE to paid loss. The filing shows that ratios of paid LAE to paid loss have increased since 2002, and that the increases experienced in 2004, 2005, and 2006 have been large. The increase in 2006 was particularly large.

The WCIRB filing lists 11 factors as potential explanations why LAE has not declined to the same degree that losses have declined. The prepared testimony of Mr. Bellusci, the WCIRB's Chief Actuary, elaborated on this subject. In his testimony, Mr. Bellusci acknowledged that some of the LAE paid out in the recent post-reform years may be transitional and may not continue once the post-reform environment becomes more stable. He stated, however, that it was not possible to quantify the possible transitional expense element at this time. The WCIRB will be studying LAE in depth, and may change its LAE methodology in the next filing. We expect the WCIRB to follow through on this effort, and recommend that the ULAE methodology in particular be substantially revised.

In this filing, however, the WCIRB's LAE methodology is only slightly changed from previous filings. The Bureau selects the latest calendar year's ratio of paid ULAE to paid loss, which is 15.1%, for the ULAE provision. For ALAE, the Bureau selects the average of the results of its two methods: paid ALAE development and paid ALAE ratio development, where the ratio being developed is the ratio of paid ALAE to paid indemnity loss. For each of these two methods, the WCIRB selects the average of the last three accident year's ratios to loss as the method's result. The resulting selected ALAE provision is 12.0% of loss. The WCIRB's total recommended LAE provision is the sum of the ALAE provision of 12.0% and the ULAE provision of 15.1%, or 27.1% in total.

In evaluating the LAE provision, we believe there are three issues that need to be addressed. The first is to what extent the increased LAE relative to loss is due to permanent changes in the workers compensation system and to what extent the increase is due to temporary increases in expense due to litigation and similar efforts that attempt to determine how the post-reform benefit system will operate in practice. The second issue is whether and to what extent is the increase in LAE relative to loss simply due to insurers failing to reduce claims staffing and expenses in line with reduced claims costs and frequencies. To the extent that reductions have not occurred, there would be an element of excess expense in the data that would not be necessary to successfully settle claims. The third, as briefly mentioned above, is that the WCIRB methodology for determining the ULAE provision is clearly inadequate and in need of replacement by a more appropriate method or set of methods.

In his testimony, Fred Kilbourne, actuary for the Public Members of the WCIRB Governing Committee, raised this second issue. He presented a calculation of an excess LAE component which was based on the premise that LAE is directly proportional to claim frequency.

With respect to the first issue, the question as to whether there is an element of temporary increases in LAE, we accept the WCIRB's reasoning that the post-reform environment has new elements that reduce loss costs but add permanent increases to LAE. We agree with the WCIRB's assertion that medical utilization review, medical provider networks, apportionment of indemnity loss to causation, and the return-to-work provisions of the reforms can be expected to add permanent LAE components to the pre-reform expense levels.

We also expect, however, that a significant portion of the observed increase in the percentage of LAE to loss is temporary, caused by litigation and other efforts attempting to establish how the post-reform workers compensation benefit system will work in practice. Obvious examples would be litigation over the application of the 2005 Permanent Disability Rating Schedule (PDRS) to pre-2005 claims and litigation over the ability of insurers to insist that existing claimants be transferred into medical provider networks once they become effective. It would also seem to be clear that litigation over medical utilization reviews and PDRS issues in general would also involve a significant temporary component.

We accept the assertion that there is insufficient data to evaluate this issue quantitatively at this time, but do not believe it is appropriate to ignore the issue until sufficient data becomes available.

With respect to the second issue, that of possible excess expense, we agree with Mr. Kilbourne's general concern, but believe that his assumption that LAE should be directly proportional to claim frequency is an oversimplification.

We are of the opinion that market competition is not yet strong enough to provide a significant incentive to insurers to reduce loss adjustment expenses. While market competition has increased, as evidenced by the State Compensation Insurance Fund's significant loss of market share, the average industry price level relative to the pure premium rate level remains in the 1.45 to 1.50 range. As this average price level is far higher than what is necessary to provide a reasonable rate of return, it is clear that competition is not currently an effective regulator of rates. It follows that competition is not currently an effective regulator of insurer expense levels, either.

While we find it very difficult to evaluate the "excess expense" issue on an industry-wide basis, we have observed that the State Compensation Insurance Fund has exhibited dramatic growth in its LAE ratios in 2005 and 2006. Based on a simple analysis of Annual Statement Schedule P data, SCIF's calendar year ratios of paid ULAE to paid loss went from 13.2% in 2003 and 12.3% in 2004 to 18.4% in 2005 and 21.0% in 2006. SCIF's ratio of incurred LAE to incurred loss went from 17.9% for accident year 2004 to

18.0% for accident year 2005, and increased significantly to 23.6% in 2006. While SCIF's ALAE ratios were relatively unchanged at near 5%, its ratio of incurred ULAE to incurred loss went from 12.9% for accident year 2004 to 13.1% for accident year 2005, and increased to 18.9% in 2006. This trend has continued into 2007; as shown in SCIF's 2006 Annual Statement and its June 2007 Quarterly Statement filed with the Department of Insurance, its ratio of incurred LAE to incurred loss was 15.2% for calendar year 2004, 20.8% for calendar year 2005, 32.1% for calendar year 2006, and 36.5% for the first half of 2007.
As mentioned previously, we note that SCIF's market share has declined significantly. On a net of deductible basis, SCIF's market share was 53% in 2003, and has fallen to 31% in 2006, based on WCIRB statistics presented in their response to our informational request made at the hearing. This is a reduction of over 40%. On the Bureau's gross of deductible basis, SCIF's share has fallen from 36% to 22% in the same period, a reduction of almost 40%.

Based on this information, we are of the opinion that SCIF's increases in LAE ratios are not indicative of its post-reform expense requirements, but are instead largely due to its inability to reduce claims staffing as fast as its claims handling workload is reduced due to its reduced market share. Since SCIF's data is still a significant percentage of the total industry data, it appears that there is a significant element of excess LAE in the industry data.

We have obtained loss adjustment expense data from the WCIRB for the total California workers compensation insurance industry excluding the experience of the SCIF. Because of the concerns expressed above, we have decided to base our estimates of the needed loss adjustment expense provision in the pure premium rates on the industry experience excluding the experience of SCIF.

We also note that the WCIRB's projections of accident year ALAE by both methods over the last several years are fairly consistent, in marked contrast to the calendar year ratios presented, which show a consistent uptrend since 2001 and a very substantial jump in 2006. There appears to be significant distortion in the calendar year ALAE ratios that is not present in the accident year ratios. Given that this is the case, we believe it is reasonably likely that distortions also exist in the calendar year ULAE ratios the WCIRB is relying on to determine its recommended ULAE provision. This underscores the need for the Bureau to adopt new and much better methods of determining the ULAE provision.

Considering these three issues: the presence of non-recurring loss adjustment expenses during the transition to the post-reform era, the likely presence of excess LAE in the most recent data, and the likely distortions in the calendar year ULAE ratios, we have decided to base our estimate of the required loss adjustment expense provision on the two-year average of the methods presented by the WCIRB, based on industry experience excluding the experience of the State Fund. We believe this approach provides an appropriate tempering of the distorted ratios from the most current year.

For ULAE, we select the average of the ratios of the latest two years. Since the ratio for calendar year 2005 excluding the experience of the State Fund is 8.0%, and the ratio for 2006 is 9.9%, our selected provision is the average of the two, or 9.0%. This is in contrast to the provision excluding the experience of the State Fund of 9.9% based on the WCIRB method of choosing the ratio for 2006 alone.

For the paid ALAE development method, the ratio of estimated ultimate ALAE to ultimate loss for accident year 2005 excluding the experience of the State Fund is 17.9%. The ratio for 2006 is 17.7%. The average of these two ratios is 17.8%, which is our selection for the method. Similarly, for the paid ALAE ratio development method, the ratio of estimated ultimate ALAE to ultimate indemnity loss for accident year 2005 excluding the experience of the State Fund is 42.7%, while the ratio for 2006 is 42.4%. The average of the two is 42.55%. When converted to a ratio to total loss, this ratio is 14.4%. This is our selection for the paid ALAE ratio development method. We average the values from the two methods to arrive at our final estimate, using the same approach as the Bureau. As a result, we arrive at an ALAE provision of 16.1%.

The WCIRB filing methodology was to select the average of the ratios for the latest three accident years for each of the two methods, and then select the average of the two methods as the ALAE provision. When applied to the data for the industry excluding the experience of the State Fund, this produces results virtually identical to our estimates. For the paid ALAE development method, the WCIRB method would produce an estimate of 18.7%, as compared to our estimate of 17.8%. For the paid ALAE ratio development method, the WCIRB method would produce an estimate of 15.5%, as compared to our estimate of 14.4%. The average of the values from the two methods in our analysis is 16.1%, while it is 17.1% using the Bureau's method.

Combining our selected ALAE provision of 16.1% with our selected ULAE provision of 9.0%, we arrive at a total LAE provision of 25.1%. This compares to the WCIRB provision of 27.1%.

As explained in the section on AB 338, we make one further adjustment to the LAE provision. We assume that the increase in LAE due to AB 338 will be only half of the increase in losses due to that legislation. Since we accept the WCIRB's estimate that AB 338 will increase losses by 1.0%, we assume that LAE will increase by 0.5%, and that the ratio of LAE to loss will decrease by approximately 0.5%. This lowers our final LAE provision from 25.1% to 25.0%.

**Pure Premium Rate Level Impact**

As stated above, we have accepted the WCIRB estimate of the effect of AB 338 on losses. As we have no objections to the analysis of loss experience, we have accepted the WCIRB estimate of the indicated loss portion of the prospective pure premium rates.

As indicated in the preceding section, we have selected a loss adjustment expense provision of 25.0% of losses, instead of the WCIRB LAE provision of 27.1% of losses. This selection results in a decrease to the WCIRB's filed pure premium rate level increase of 5.2%. Our recommended pure premium rate level change is an increase of 3.5%.

**Uncertainty in the Evidence Presented**

While we believe we have applied reasonable judgments in our analysis in this Proposed Decision, and have produced reasonable estimates of the effects of AB 338 and of the needed loss adjustment expense provision, there exists a large degree of uncertainty in our estimates and in the estimates presented by the WCIRB.

In the evaluation of AB 338, the Bureau used pre-reform data out of necessity, but acknowledged that changes in duration of temporary disability were likely in the post-reform environment, and that these changes would limit the applicability of the pre-reform data. While the Bureau made a judgmental adjustment to its estimate based on the pre-reform data, the lack of sufficient post-reform data creates a significant degree of uncertainty in the estimate.

Loss adjustment expenses have increased significantly as a percentage of losses in recent calendar years. Much of this increase is clearly attributable to increased litigation and evaluation during the transition period while the new post-reform ground rules are being worked out in the courts and in settlement negotiations on individual claims. These expenses are transitory rather than permanent, and should not be provided for in the prospective pure premium rates to the extent they will not be applicable to claims on 2008 policies. Since there is currently no hard data on which expenses are transitional and which are permanent, there is a significant degree of uncertainty as to how much loss adjustment expense will be ongoing.

It is also unclear how much of the increase in loss adjustment expense is caused by insurers' delayed reactions to the reduced level of claims and claims costs in the post-reform environment. It appears that at least one major insurer, the State Compensation Insurance Fund, has not reduced its claims staffing as quickly as its reduced claim volume would warrant. We do not know to what extent this is an issue for other insurers. This also introduces a significant element of uncertainty.

Finally, the WCIRB's reliance on calendar year ratios of ULAE to loss appears to introduce a third major source of uncertainty. It is clear that the calendar year ratios of ALAE to loss are distorted, due probably to the rapid decline in accident year loss volume and the fact that both loss and ALAE are paid out over many years. It seems obvious that the ULAE ratios could be distorted as well, but we do not know the extent of the possible distortion.

**WCIRB Ratemaking Process Review**

In his most recent prior Decision, the Commissioner ordered the WCIRB to "evaluate and utilize different methodologies and review alternative viewpoints in making its recommendations to me". In the Proposed Decision, we directed the WCIRB to review its ratemaking process, addressing why pure premium rates were so inadequate from 1995 through 2002 and so redundant from 2004 to the present, producing recommendations for changes in the pure premium ratemaking process. Our discussion considered these two periods separately.

For the pre-reform period we considered the inadequacy of the loss development methods. We also said that there is a need for better information regarding current conditions, in order to identifying turning points in loss experience and trends can be identified early. The WCIRB has complied with the Commissioner's order that the special committee of claims specialists and legal experts that was assembled to consider the reform legislation be made permanent.

For the post-reform period we criticized the WCIRB for its excessive caution. For the medical utilization reforms, the WCIRB discounted the study by Frank Neuhauser that predicted substantial reductions in costs. For the permanent disability changes, the WCIRB had studies by Mr. Neuhauser and by Dr. Christopher Brigham that indicated substantial savings were likely. The WCIRB continued to significantly temper the estimates, even as the evidence mounted that the studies had been reasonably accurate.

We finished our discussion by focusing on exhibits 6 and 7 of the WCIRB's filing. (Exhibit 7 is a graphical representation of numbers calculated in exhibit 6.) We noted that, although these are labeled as "on-level", meaning they are supposed to represent what past claims experience would have looked like had current wage, pure premium, and benefit levels been in effect, they are nowhere near to actually looking level. They instead show that some vital piece is missing from the trend evaluation.

The WCIRB has told us, based on this discussion, that it is considering retaining an outside actuarial consulting firm to assist with a comprehensive review of the WCIRB's ratemaking methodologies. In order to give the WCIRB a better understanding of what we expect from such a study, we provide the following additional comments.

The study should look beyond traditional actuarial loss development and trending techniques. In particular, there are possible improvements that could be made in loss development, such as adding the Berquist-Sherman methods to the alternatives considered or separately developing different injury types or slicing the data in other ways. These should be explored. However, looking back again at the above-mentioned exhibit 7, even if the WCIRB's loss development methods were perfect, they would still find making accurate trend selections difficult. Exhibit 7 is based on current best estimates of loss development and effectively removes past misestimates. Yet even if we had had these current estimates for the prior accident years available in 1997, for

example, we would not have been able to predict from them the large increases in cost that would eventually emerge for 1998.

While loss development methodology needs improving, the primary focus should be on the on-level calculation, on trending, and on identifying leading indicators.

Despite the substantial changes in the claims system, first leading to a doubling of the on-level medical to pure premium ratio from .356 in accident year 1993 to .780 in 2000, the WCIRB's on-level factors in this period only range from .979 to 1.075. The factors take into account such changes as in medical inflation, fee schedules and utilization due to indemnity benefit changes. The portion of the on-level factors "to reflect legislative and regulatory changes" (which only applies to the proportion of medical costs not subject to fee schedules) ranged only from .797 to .898, with almost all of the change occurring between 1993 and 1994. During this time, severity (expressed as ultimate medical, excluding medical only, per indemnity claim) went from $10,062 in 1994 to $22,964 in 2000, increasing by double-digits every year. Clearly, the on-level factors don't even attempt to capture the major impacts of the changes that were taking place.

A similar tale can be told about the subsequent drop in the on-level medical to pure premium ratio from .765 in accident year 2002 to .512 in 2006. Notably missing is any significant on-leveling adjustment for the impact of the medical fee schedule change or the various medical utilization reforms. For indemnity, the corresponding numbers are an increase from .346 to .535 and a decrease from .500 to .272. The indemnity decrease persists even after making a substantial adjustment to reflect the change in the permanent disability rating schedule.
The intent of an on-level process should be to quantify and remove all identifiable and quantifiable changes. The end result should be a residual time series that shows a few small, random fluctuations and perhaps a trend that can be extracted with smoothing, fitting or filtering techniques. Exhibit 7 shows that the result of the WCIRB methodology is very far from this goal.

It appears that what is needed is a deeper, more detailed understanding of the claim and medical treatment processes. The WCIRB needs to get a better grasp on the dynamics that influence claim frequency and severity that goes beyond fee or disability rating schedules.

The WCIRB is projecting about 146,000 indemnity claims for accident year 2006. Although there are many more medical-only claims, indemnity claims account for the great bulk of the claims dollars. From the perspective of given current data technology capabilities, this is not an overwhelmingly large number. The number of body parts is limited and the variety of possible injuries, their treatments and courses, while large, is finite, especially now that guidelines are in place.

The actuarial profession has seen an explosion of new approaches that take advantage of the new technologies, which range from catastrophe modeling to predictive modeling to data mining. There also now exist very rich transactional data bases, such as that

maintained by the California Workers Compensation Institute. The time seems ripe for the WCIRB to apply these new approaches to richer, more dynamic data bases. The WCIRB and the consulting actuary should explore the feasibility of identifying within these data bases such things as leading indicators or diagnostics that can identify early on that the system is changing.

As noted above, the WCIRB has complied with the Commissioner's order to establish a standing committee of claims and legal experts. The WCIRB and the consulting actuary should carefully evaluate this process of gathering information from the new standing committee and translating it into quantifiable and testable data that can be fed directly into the ratemaking process.

In the past, the WCIRB has explored econometric modeling. The "utilization effect" adjustment that is applied to benefit changes is the most obvious example. While we have been occasionally reluctant to follow the WCIRB in extending the result of the model from indemnity frequency to medical, we have accepted the basic premise and have been allowing the indemnity adjustment for ten years. Here is evidence of the feasibility and usefulness of going beyond the traditional actuarial methods of loss development, trend and tabular approaches to quantifying benefit changes. Yet the amount of data underlying this adjustment is relatively small, even considering the many alternatives that were considered and extensively analyzed before arriving at the final model.
It is time for the WCIRB to explore the more data-intensive research that current state of the art allows, and the WCIRB is directed to work towards this goal and report back on the options that it may pursue after it completes its actuarial review.

**Workers' Compensation Insurer Profitability**

Exhibit 3 of the WCIRB's letter to us dated October 30, 2007 shows that recent accident years have been very profitable for insurers. Combined loss and expense ratios were 79% for accident year 2003, 56% for 2004, 51% for 2005, and 63% for 2006. These are considerably lower than the national combined ratios of 88% and 87%. The California number crept up slightly in 2006, as the WCIRB pure premium rates began to more accurately reflect the effects of the reform, but nevertheless 2006 was a very profitable year.

Combined ratios do not reflect investment income. When investment income is also factored in, using standard actuarial ratemaking formulas (such as the proposition 103 rate formula) and various assumptions on expenses, reserves, yield, taxes, leverage and rate of return[1] , we have calculated that an insurer can make a reasonable profit at a

These assumptions are: 16.7% acquisition, general expenses and premium tax, 3.09 ratio of loss reserves to incurred losses, .22 ratio of unearned premium reserve to earned premium, 6.72% yield on invested assets, including unrealized capital gains, 32.88% federal income tax on investment income and 35% federal income tax on underwriting profit, premium to surplus ratio of 1-to-1 and 10.88% after-tax rate of return on statutory surplus.

combined ratio of 112%. To put it another way, the shortfall of 12% above the amount necessary to pay for claims and expenses, is handily covered by investment income and should leave enough left over for a healthy profit.

Another way of considering profitability is looking at the ratio of premium to pure premium. We previously calculated that a workers compensation insurer can be reasonably profitable at a premium-to-advisory-pure-premium ratio of 1.05.

Every quarter the WCIRB submits solvency monitoring data to the Department that, among other things, reports the industry-wide insurer rate levels as a ratio of the approved advisory pure premium level. Since the beginning of open competition in 1995, this ratio has varied from .952 in 1999 up to 1.508 for written premium in the fourth quarter of 2006. These numbers are industry-wide ratios and individual companies will have ratios that are higher or lower. In 1999 some companies may have had ratios as low as .800.

The most recent actual industry-wide ratio of 1.471 exceeds our calculated target of 1.05 by more than 40%. Using the same ratemaking formula and assumption, a 1.471 ratio produces an after-tax return on statutory surplus of over 20%. This still represents an opportunity for premium reductions beyond the prior decreases in the advisory pure premium we have previously proposed and despite our recommendation to increase the advisory rates as a result of other factors, since the premiums charged have not decreased in line with our recommendations.

## OTHER MATTERS

### Amendments to the California Workers' Compensation Uniform Statistical Reporting Plan—1995

The WCIRB has proposed amendments to the California Uniform Statistical Reporting Plan—1995 to be effective on January 1, 2008 with respect to new and renewal policies as of the first anniversary rating date of a risk on or after January 1, 2008. Those amendments include the following:

- the effective date of the amendments; changes for clarity, consistency, correction, and/or editorial purposes as noted in the filings;
- amendments to the provisions concerning dual wage classifications for construction and erection classifications regarding the records required to support the assignment of employees to the higher wage classification;
- amendments to adjust the minimum and maximum payroll limitations;
- amendments to clarify the audit requirements;
- amendments to adjust various annual payroll limitations for various classifications and to adjust the hourly wage thresholds in dual wage classifications to reflect wage inflation;
- amend classification 8850 to specifically reference deferred deposit transactions in the footnote;

- eliminate classification 4360 and incorporate it into classification 9610, with appropriate additional amendments to classification 9610, as a single classification to better describe the motion picture production industry; and
- amend classification 4362, Motion Picture—film exchanges to include the operations of motion picture film developers and processors and remove the inclusion of Clerical Office Employees;

A written comment was received objecting to the changes to the payroll documentation required for dual wage classifications stating that the current proposal was not compatible with Wage Order 16 issued by the California Industrial Welfare Commission. The WCIRB made a written reply to this comment on October 30, 2007 stating that the proposed change was compatible with Wage Order 16. Wage Order 16 was reviewed, since a website link to it was provided in the comment. Wage Order 16 requires accurate payroll records to be kept for certain on-site occupations in construction. Wage Order 16 gives minimum standards of what is required and does not set any limit on how detailed the information may be documented. The changes proposed by the WCIRB do not contradict or interfere with the requirements of Wage Order 16. Actually, the WCIRB's proposal requires detailed wage information, to support an employer's classification of an employee into a higher wage for a dual wage construction classification, which would meet or exceed that required in Wage Order 16. The proposal of the WCIRB is needed to provide the necessary documentation to support a higher wage classification for construction employees subject to the dual wage classification and is approved.

The remaining amendments to the California Workers' Compensation Uniform Statistical Reporting Plan—1995 have been reviewed and, having received no objections regarding them, are approved as being reasonable and consistent with the purpose of this Plan.

**Amendments to the Miscellaneous Regulations for the Recording and Reporting of Data**

The WCIRB has proposed amendments to the Miscellaneous Regulations for the Recording and Reporting of Data to be effective on January 1, 2008 with respect to new and renewal policies as of the first anniversary rating date of a risk on or after January 1, 2008. Those amendments include the effective date of the amendments and a change to correct proper Rule citation.

These amendments have been reviewed and, having received no objections regarding them, are approved as being reasonable and consistent with the purpose of these Miscellaneous Regulations.

**Amendments to the California Workers' Compensation Experience Rating Plan—1995**

The WCIRB has proposed amendments to the California Experience Rating Plan—1995 to be effective on January 1, 2008 with respect to new and renewal policies as of the first anniversary rating date of a risk on or after January 1, 2008. Those amendments include the following:

- Changes to the effective date of the amendments to January 1, 2008;
- Amendment to Section III to adjust the eligibility requirement for experience rating from $13,728 to $15,000 to reflect wage inflation and the amendments in pure premium rates proposed in this filing based upon the increase of 5.2.% of the Pure Premium Rates;
- a change to correct proper Rule citation;
- amendments to the expected loss rates and D-ratios to reflect the most current data available;
- amend the average death value to reflect the most current data available

Comments were received, both in writing and in testimony at the hearing of October 23, 2007, objecting to the WCIRB's proposal to amend the expected loss rates (ELR) and D-ratios shown in Table II of the Experience Rating Plan to reflect the most current experience available. The objections came from both employers and insurance agent/brokers stating that the proposed changes would adversely affect the workers' compensation premium pricing of experience rated employers.

The ELR and D-ratios were previously modified with the July 1, 2007 Pure Premium Rate Decision and Order, and similar opposition testimony was received at that time. As a result of that prior opposition, the Insurance Commissioner recognized the concerns voiced in the objections but also recognized the need to maintain consistency with the current Plan until appropriate changes to the Plan were approved, and the WCIRB was directed to re-evaluate the Experience Rating System. Specifically, the WCIRB was to re-evaluate the Experience Rating System in light of the changes to the workers' compensation system and to explain how the current system complies with Insurance Code Section 11736, particularly with regard to providing adequate incentives for loss prevention and sufficient premium differentials so as to encourage safety. The WCIRB was directed to report back with a plan on any changes to the system by July 1, 2008. We expect that the WCIRB will understand the urgency of this issue.

We recommend that the proposed expected loss rates and the proposed change in experience rating off-balance be approved, but the WCIRB is directed to carefully evaluate recent changes in expected loss rates and experience rating modifications to determine whether or not the experience rating plan has functioned appropriately in the last few years.

We do not recommend disapproving the proposed expected loss rates, as some have recommended, because to do so in isolation would create a significant shortfall in pure premiums after experience rating. If this shortfall was not corrected, the experience

rating plan would not be in balance. If it were corrected by increasing the off-balance correction factor, a substantial increase to the overall pure premium level would be necessary, and would unfairly penalize non-experience rated risks, which consist mainly of small employers.

It is apparent that a careful review of this subject is needed. We note that there have been significant swings in the average modification in recent years, as shown in Appendix E, Exhibit 1 (Page A:B-119) of the filing. As shown on line 1 of the exhibit, the average modification was .959 for policy year 2004, 1.004 for 2005, .905 for 2006, and .953 for policy year 2007 on a preliminary basis. These swings of 5% to 10% seem excessive for industry-wide averages. Furthermore, the correction factors shown on line 5, which range from .927 for 2005 to 1.152 for 2006, appear unusually large. These correction factors indicate the percentage error in the WCIRB's estimation of the overall losses underlying the expected loss rates for the indicated policy year (based on current estimates of ultimate loss). The overestimation of 15.2% for policy year 2005, in particular, appears to have caused the low average modification of .905 for that policy year. We believe it is necessary to correct this misestimation through the experience rating mechanism and not through the overall pure premium level. We also recommend that the WCIRB be directed to review the functioning of the experience rating plan and to determine how errors of this magnitude can be avoided in the future.

The remaining amendments to the California Workers' Compensation Experience Rating Plan—1995 have been reviewed, and no further objection to them has been received. These amendments are also reasonable and consistent with the Plan and are approved; however, we have concluded the change of the Pure Premium Rates should be +3.5%. Therefore, the WCIRB is directed to adjust the eligibility threshold to reflect the Insurance Commissioner's adopted Pure Premium Rates in order to maintain approximately the same volume of experience rated employers.

**WCIRB Advisory Plans**

The WCIRB has submitted to amendments to various advisory plans for review by the Commissioner. These amendments do not require the approval of the Commissioner; however, the amendments to the California Retrospective Rating Plan, California Large Risk Deductible Plan, and California Small Deductible Plan have been reviewed and the amendments noted.

# PROPOSED ORDER

WHEREFORE, IT IS ORDERED, by virtue of the authority vested in the Insurance Commissioner of the State of California by California Insurance Code sections 11734, 11750, 11750.3, 11751.5, and 11751.8 that the advisory workers' compensation Pure Premium Rates and Sections 2318.6, 2353.1 and 2354 of Title 10 of the California Code of Regulations are hereby amended and modified in the respects specified herein;

IT IS FURTHER ORDERED that the experience rating threshold be calculated to reflect the Pure Premium Rates adopted herein;

IT IS FURTHER ORDERED that these regulations shall be effective January 1, 2008 for all new and renewal policies with anniversary rating dates on or after that date.

I HEREBY CERTIFY that the foregoing constitutes my Proposed Decision and Proposed Order in the above entitled matter as a result of the hearing held before me as a Senior Staff Counsel of the Department of Insurance on October 23, 2007, and I hereby recommend its adoption as the Decision and Order of the Insurance Commissioner of the State of California.

November 28, 2007

_____/s/_____
Christopher A. Citko
Senior Staff Counsel